EQUITY

Seeing the Big Picture in Market Corrections

February 7, 2018

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While we don't know when the equity market's recent volatility will settle down, it's important to consider the big-picture, fundamental backdrop for the market, and not get caught up in short-term sentiment swings, according to Franklin Templeton's head of equities, Stephen Dover. And, he believes the fundamental backdrop still looks solid.

Recently, we've seen equity markets pull back amid concerns that rising rates, inflation and slower growth could erode profitability for companies.

On Monday, February 5th, the US equity market experienced a sudden bout of volatility. The Dow Jones Industrial Average logged its largest-ever point decline to close down just over 1,175 points, although it had briefly dropped nearly 1,600 points during the day. It was the index's largest one-day percentage decline since August 2011. The ripples were felt around the world as Asian and European equity markets followed suit on Tuesday, February 6.

The suddenness of the market decline has left some market observers searching for an explanation, with one being a recognition that the era of cheap money globally appears to be ending.

However, equity investors have had good returns for many years now, so we view a market correction as healthy. When you consider the markets have had a relatively strong, unprecedented rise the past couple of years, market corrections can serve as an opportunity to improve valuations so it's not quite as expensive to buy stocks. This helps to make new portfolio allocations more efficient.

Investors should not confuse the market for the economy. We have seen real, solid, economic growth globally. Companies that have low levels of debt, good earnings visibility, pricing power and positive cash flow should be able to do well even in an environment of tighter monetary policy and rising interest rates.

It's important to stress that while markets can be volatile in the near term, over the long term, they reflect the underlying fundamentals of companies and countries. In our view, long-term structural growth drivers are still in place, and a slight rise in interest rates or inflation should not have a significant detrimental impact. Consumer spending, infrastructure, technological innovation/adaptation are the long-term structural drivers of global growth, along with health care innovation.

We recognize that challenges remain across the globe. Structural reform (while often unpopular) is needed in some countries. Elections can bring uncertainty and change, and there is always the possibility of policy errors or unexpected geopolitical shocks.

Staying the Course

In times of market turmoil, it's tempting to focus on the short term. However, it's important to consider one's long-term investment horizon and why you are investing, whether it's for retirement, your children's education or some other goal.

Market returns may vary over time, but as long as the world economy remains healthy and companies continue to innovate and grow, we think there is still a case for staying invested in equities for the potential growth we see likely ahead.

Most investors have significant investments in their home countries, which in the realm of behavioral finance is called home-county bias. For US-based investors, we think a potentially weaker dollar could lead to opportunities outside the United States. For all investors, we think there's a case to be made for diversifying across asset classes and markets to help protect against the negative impact of a single event. Additionally, in times of volatility, we think active management can really prove its worth. We recommend investors consult with a financial advisor to determine the most appropriate portfolio allocations for their situation.

The recent market noise has not changed our view of the world. While additional volatility may follow, we remain optimistic about the coming year.

Hear more of Stephen's outlook for the year ahead, including potential challenges and opportunities.

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